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Compliance with the Formal Approval Requirements of Delaware Law Required for Stockholder Ratification of Director Compensation

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On October 28th, the Delaware Chancery Court, in *Espinoza v. Zuckerberg*, et al. ("*Espinoza*")[1], held that stockholder ratification of a transaction that was approved by an interested board of directors must be accomplished formally through a vote at a stockholders' meeting, or by written consent in compliance with § 228 of the Delaware General Corporation Law (the "DGCL").[2] In answering this question of first impression, the Court found that Facebook's controlling stockholder, Mark Zuckerberg, did not provide valid ratification of what the parties agreed was a self-dealing transaction when he expressed his approval of Facebook's non-employee director compensation in a deposition and affidavit.

Espinoza arrives at a critical time for many companies, as they consider the validity of the stockholder approval of their own non-employee director compensation arrangements in light of recent Chancery Court decisions concerning the ratification of non-employee director compensation. In both *Calma v. Templeton*[3] ("*Calma*") and *Seinfeld v. Slager* ("*Seinfeld*")[4] ,the

1 *Espinoza v. Zuckerberg*, *et al*., CA No. 9745-CB (Del. Ch. Oct. 28, 2015).

2 Under Delaware law, the decisions of an independent board of directors are protected by the business judgment rule, and the burden falls on the plaintiff to prove that there exists the "rare type of facts from which it is reasonably conceivable that the compensation awards constituted corporate waste." If the directors are interested in the transaction, meaning they will receive a benefit that does not accrue to stockholders generally, the standard of review will shift to entire fairness and the burden will be on the defendants to establish that the transaction was the product of both fair dealing and fair price. Interested directors, however, may still be afforded the protection of the business judgment rule if a fully-informed disinterested majority of stockholders ratifies the transaction.

3 *Calma v. Templeton*, CA No. 9579-CB (Del. Ch. April 30, 2015).

4 *Seinfeld v. Slager*, 2012 WL 2501105 (Del. Ch. Jun. 29, 2012).

Chancery Court held that stockholder approval of an omnibus equity incentive plan would not constitute ratification of non-employee director compensation in the absence of specific or meaningful limits in the plan on the amount of compensation that could be awarded to the non-employee directors. As a result, each case survived a motion to dismiss, and the transactions at issue would be judged under the entire fairness standard of review.

While *Calma* and *Seinfeld* focus on the content of the stockholder approval, *Espinoza* focuses on the process through which stockholders express their approval of a corporate action for purposes of ratifying the action. Although there are no statutes or cases requiring that stockholder approval for purposes of ratification be accomplished through the formal means of the DGCL, the Court looked to existing case law on stockholder ratification, as well as the policies underlying the DGCL, to support its conclusion. With respect to existing case law, the Court focused on the use of the word "vote" in the definition of "ratification" being applied by Delaware Courts. With respect to policy, Chancellor Bouchard noted that the provisions of the DGCL that govern the ability of stockholders to take corporate action serve to ensure that the corporate action being approved is clearly defined and that minority stockholders - whose rights are affected - are given prompt notice of the approval after the fact.

Due to the informal nature of Mr. Zuckerberg's approval of Facebook's non-employee director compensation (which occurred following the filing of the lawsuit), and the fact that at that stage of the proceedings the defendants had yet to demonstrate that the transaction was the product of fair dealing and fair price, the Court denied the directors' motion for summary judgment. Therefore, absent settlement, the case will move to trial and the directors will have to prove that the compensation was entirely fair to the company.

Following *Espinoza*, those companies wishing to protect their directors from challenges to their non-employee director compensation programs through stockholder ratification must ensure compliance with both the specificity commands of *Calma* and *Seinfeld*, as well as the stockholder approval requirements of the DGCL. Relying on the informal acquiescence of a controlling stockholder, or the results of a non-binding say-on-director pay vote, will not ensure that the directors are protected by the business judgment rule in the face of a stockholder challenge. Further, although *Calma* and *Seinfeld* focused solely on the equity portion of the non-employee director compensation, the Chancery Court in *Espinoza* also reviewed the cash retainer Facebook paid to its non-employee directors. This discussion by the Court serves as a subtle reminder that companies seeking stockholder approval of non-employee director compensation should seriously consider including cash payments in the compensation to be ratified by the stockholders.

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[5] *See Espinoza* at 27 quoting *Gantler v. Stephens*, 965 A.2d 695 (Del.Supr. 2009) ("the shareholder ratification doctrine must be limited… to circumstances where a fully informed shareholder vote approves director action that does *not* legally require shareholder approval in order to become effective") (italics in original).

[6] The Court did, however, grant defendants' motion to dismiss plaintiff's claim for waste because plaintiff failed to plead particularized facts that "lead to a reasonable inference that the director defendants authorized an exchange so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration" (*Espinoza* at 37 (citing *Seinfeld* at 7)).

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